

**STATE BOARD OF EQUALIZATION**

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October 24, 1994

BURTON W. OLIVER
Executive Director

Mr. B--- C---
P. O. Box XXX
---, CA XXXXX

Re: **Manufacturing Equipment Exemption**
Rev. & Tax. Code § 6377 (SB 671; SB 676)

Dear Mr. C---:

This is in response to your letter received by us on January 11, 1994 regarding your company's ability to qualify for the partial sales and use tax exemption contained in Revenue and Taxation Code section 6377. We delayed responding while the Board worked on the regulation to interpret and apply Senate Bill ("SB") 671 with industry's assistance. We also waited while the Legislature worked out the kinks in the partial sales and use tax exemption through the passage of SB 676. We can now provide you answers with more certainty than we could have previously. We apologize for the delay in processing your letter.

You state that you hope to open a small welding/fabrication shop. This business will start with a welding service truck which you will use to perform repairs and fabrication work at customer job sites. You also plan to undertake "scrap iron/dismantling" jobs to supplement your income. For purposes of this letter, we assume that you will be operating as a sole proprietor with no other persons employed by your business.

Before answering your individual questions, an overview of the partial sales and use tax exemption may be helpful in understanding our responses. The sales tax imposed in California is comprised of several components. One is the state component which currently totals 6 percent. (Rev. & Tax. Code §§ 6051, 6051.2, 6051.3, 6051.5 (similarly, the state component of the use tax also totals 6 percent).) Another component is the tax imposed pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law, which is imposed at the rate of 1-1/4 percent. (Rev. & Tax. Code § 7200 et seq.) Any sales tax above 7-1/4 percent is imposed pursuant to the Transaction and Use Tax Law. (Rev. & Tax. Code § 7251 et seq.)

Revenue and Taxation Code section 6377 was originally enacted by SB 671. As enacted by SB 671, section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. Even when a sale satisfies the exemption, the tax imposed above 6 percent (at least 1-1/4 percent, plus any transactions tax imposed in the relevant district) remains due. Section 6377 was recently amended by SB 676, which becomes operative on January 1, 1995. As of January 1, 1995, the exemption provided by section 6377 is reduced to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 exemption occurs in 1994 in a district where the sales tax rate is 7-3/4 percent, tax of 1-3/4 percent is due. If a qualifying sale occurs in that district in 1995, tax of 2-3/4 percent is due. For the remainder of this opinion, I will refer to the section 6377 exemption as a partial sales tax exemption (exemption from tax of 6 percent during 1994 and 5 percent thereafter).

The partial sales tax exemption applies to persons that commence a new trade or business (discussed below) in those lines of business described in codes 2000 to 3999 of the 1987 Standard Industrial Classification Manual (hereafter "SIC code"). A person meeting both these requirements is a "qualified person"; however, a "qualified person" does not include any trade or business that was used in any predecessor trade or business conducted by the taxpayer or any other taxpayer related to the taxpayer (within the meaning of Sections 267 and 318 of the Internal Revenue Code). The partial sales tax exemption generally applies to purchases of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development (hereafter "qualified activity") and the repair of qualified property.

As an alternate to the partial sales tax exemption, SB 676 provides an investment tax credit (Rev. & Tax. Code § 17053.49) for purchases of "qualified property"¹ by persons engaged in those lines of business described in SIC codes 2000 to 3999. The investment tax credit allowed by SB 676 equals 6 percent (1 percent higher than the partial sales tax exemption contained in SB 676) and is allowed only where the qualified taxpayer does not elect to take the partial sales tax exemption. (Rev. & Tax. Code § 17053.49(a)(1); (b)(1)(B).) A copy of SB 676 is enclosed for your review.

You ask:

"Does my welding/fabricating mean the same as the word fabricating as used in the Board of Equalization flier?"

¹ "Qualified property" for purposes of the investment tax credit is defined in Revenue and Taxation Code section 17053.49(b)(6)(i).

"Fabricating" means "to make, build, create, produce, or assemble components or property to work in a new or different manner." (Rev. & Tax. Code § 6377(b)(1).) We assume that the "welding/fabrication" operations of your company constitute fabricating and would fall within a SIC code somewhere between 3441 (Fabricated Structural Metal) and 3449 (Miscellaneous Structural Metal Work). Nevertheless, the undertaking of fabricating operations does not automatically entitle your business (assuming it constitutes a "qualified person" as discussed below) to the partial sales tax exemption. To qualify, the tangible personal property purchased for use by the qualified person must be used at least 50 percent of the time in the qualified activity. (Rev. & Tax. Code § 6377(b)(3).) You state that your business will consist of repair and "scrap iron/dismantling" operations in addition to fabricating operations, but do not provide a percentage breakdown of these operations, or whether equipment purchased by your business would be used in both operations. As such, the partial sales tax exemption applies only if your business constitutes a new trade or business and the property purchased subject to the partial sales tax exemption is used at least 50 percent of the time in your fabricating or other qualified operations, if any.

"Does scraping/dismantling fall under the same category as recycling of property?"

We assume that your company's "scraping/dismantling" operations involve the disassembly of metal parts for sale to a recycling plant and not the actual reprocessing or transformation of scrap parts to other raw materials. This type of activity does not qualify as "recycling" and therefore does not qualify for the partial sales tax exemption set forth in Revenue and Taxation Code section 6377.

"I have my local business license but don't plan to start the business until well after January 1, 1994. Will the fact that I already have my business license disqualify me from getting an exemption certificate?"

A new trade or business is one which a person (or any related person) has not engaged in within the preceding 36 months inside this state² or which is classified in a different division of the SIC code than that person's (or any related person's) current or prior trade or business activities in this state.³ (Rev. & Tax. Code § 6377(b)(5)(A)(ii).) In addition, to qualify as a new trade or business for purposes of the partial sales tax exemption, it must commence such

² SB 676 makes a distinction between persons engaged in a trade or business inside the state and those that are not. Persons engaged in business wholly outside the state who commence doing business in California after December 31, 1993 (other than by purchase or acquisition of an existing business) qualify as a new trade or business regardless of that person's prior trade or business activity. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).)

³ New trade or business status also includes persons who, under certain circumstances not applicable here, acquire the assets of another business.

business operations inside the state on or after January 1, 1994. (Id.) Generally, we regard business operations to begin on the date a seller's permit is or should have been obtained for the business operation.

You do not state whether you (or any related person) engaged in a welding/fabrication business in this state within the previous 36 months. You also do not state whether you obtained (or should have obtained) a seller's permit for your welding/fabrication operations prior to January 1, 1994. If you (or any related person) have not engaged in a welding/fabrication business within the previous 36 months and did not, nor were required to, obtain a seller's permit for these operations prior to January 1, 1994, your welding/fabrication business falls within the timing requirements for a new trade or business.

"Does my business fit into the categories of business as described in codes 2000 through 3999 of the Standard Industrial Classification Manual?"

Your entire business consists of both qualified and non-qualified activities. As explained above, we believe that your welding/fabrication operation is a qualified activity between SIC codes 3441 and 3449, while remaining operations such as welding repairs and scrap iron dismantling do not fall within a qualifying SIC code. The key issue, therefore, is whether that portion of your business that is qualified entitles your business to the partial sales tax exemption for purchases of tangible personal property used in the qualified welding/fabrication activity.

The Board is currently in the process of adopting a regulation to interpret and apply Revenue and Taxation Code section 6377. The proposed regulation, 1525.2, has not yet been adopted by the Board and its provisions are not yet final. Currently, Proposed Sales and Use Tax Regulation 1525.2 would allow the partial sales tax exemption where multiple activities occur at one physical location. In particular, subdivision (c)(5)(B)2(a) of Proposed Sales and Use Tax Regulation provides:

"Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports can be prepared on the number of employees, their wages and salaries, sales, or receipts, and other types of financial data such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be 'significant' for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the

taxpayer's total dollar value of payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status."

Again, please note that Proposed Sales and Use Tax Regulation 1525.2 has not yet been adopted by the Board. The Board's staff is still drafting its provisions prior to formal presentation to the Board.

Based on the foregoing, your business may qualify for the partial sales for exemption provided your work in the fabrication operations is "significant" (within the meaning of the Regulation when adopted) and you are able to generate adequate and sufficient reports on the separate fabricating activities of your business. Again, however, only purchases of tangible personal property which will be used at least 50 percent of the time in the qualified activity are entitled to the partial sales tax exemption. (Rev. & Tax. Code § 6377(b)(3).)

"If I'm eligible for the exemption certificate, where and how do I apply for one?"

If you believe you qualify for a Revenue and Taxation Code section 6377 exemption certificate, you must complete a BT-231 form available at your local district office of the Board. If you qualify, you will be issued a section 6377 exemption form you can use to purchase qualified tangible personal property exempt from a portion of state sales and use tax. Sales of qualified property, however, will remain subject to taxes imposed above 6 percent (sales occurring in 1994) or above 5 percent (sales occurring in 1995 and thereafter).

We trust this answers your questions regarding the partial sales tax exemption. If you have further questions about the partial sales tax exemption, please write again. If you have questions regarding the investment tax credit, please write the Franchise Tax Board - Legal Division, P.O. Box 1468, Sacramento, California 95812-1448.

Sincerely,

Warren L. Astleford
Staff Counsel

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enclosure - SB 676

cc: --- Sacramento District Office - --
Mr. Robert Lambert